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SUPREME COURT, U.S.

No. 97-1642

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1997

THE UNITED STATES DEPARTMENT OF THE ARMY,
PETITIONER,

v.

BLUE FOX, INC.
RESPONDENT.

On Writ of Certiorari to the
United States Court of Appeals
for the Ninth Circuit

BRIEF OF *AMICUS CURIAE* THE SURETY ASSOCIATION OF AMERICA IN SUPPORT OF NEITHER PARTY

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STATEMENT OF INTEREST OF *AMICUS CURIAE*

The Surety Association of America[1] is an unincorporated association of over 600 companies authorized to write fidelity or surety insurance in the United States. The sureties on almost all performance and payment bonds furnished to the United States to meet the requirements of the Miller Act, 40 U.S.C. § 270a, *et seq.*, are members of the Surety Association.

If the Department of the Army had complied with the Miller Act and required the prime contractor, Verdan Technology, Inc. ("Verdan") to provide a payment bond, the surety on that bond would have paid Blue Fox and been subrogated to Blue Fox's right to contract funds. In the vast majority of cases it is the surety, rather than an unpaid subcontractor, which claims the contract funds in competition with the defaulting prime contractor.

Existing law under the Tucker Act, 28 U.S.C. § 1491 (1996) allows suit by the payment bond surety in such circumstances,[2] but the paying surety's substantive rights are grounded in part on the equitable rights of the subcontractors whom the surety paid. Sureties, therefore, have a keen interest in the portions of this case which involve the existence and

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[1] No person or entity other than The Surety Association of America made any monetary contribution to the preparation or submission of this Brief, and counsel for the parties did not author this Brief in whole or in part.

[2] The surety is both a party to a contract with the United States (the Bond itself) *Balboa Ins. Co. v. United States*, 775 F.2d 1158 (Fed. Cir. 1985) and subrogated to the rights of the prime contractor who was in privity of contract with the United States. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S.Ct. 232, 9 L. Ed. 2d 190 (1962).

extent of Blue Fox's equitable lien and the Army's duties in disposing of the contract funds after receiving notice that Blue Fox had not been paid for its work.

Both parties have consented to the filing of this Brief.

STATEMENT OF THE CASE

The Umatilla Army Depot Switch project required construction of a substantial building complete with mechanical and electrical systems. (Choate[3] Affidavit ¶ 8 [App. 60]), Lumley[4] Aff. ¶ 3 [App. 24]).

As originally issued by the Army, the contract solicitation obligated the prime contractor to provide the performance and payment surety bonds required by the Miller Act, 40 U.S.C. § 270a, *et seq.*, (Choate Aff. ¶ 6 [App. 59], Sawyers[5] Aff. ¶ 6 [App. 63]).

On July 22, 1993, the Army's Contracting Specialist, Elizabeth K. Faler, spoke with the Army Judge Advocate General's Office in regard to the bond requirement on the project. According to Ms. Faler's Memorandum of the Conversation [App. 44], she was told that "only VERDAN could get the bonds and that we did not have a contract with

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[3] Hildegard Choate is the Army's Contracting Officer (Choate Aff. ¶ 2 [App. 58]).

[4] David L. Lumley is the president of respondent Blue Fox, Inc. (Lumley Aff. ¶ 1 [App. 23]).

[5] Erlinda M. Sawyers is a Contracting Officer for the SBA (Sawyers Aff. ¶ 1 [App. 62]).

VERDAN's subs. She was very adamant about the subject. She kept referring to VERDAN as the prime . . . "

In a memorandum of a telephone conversation later on July 22 with the Small Business Administration ("SBA"), Ms. Faler recognized that Verdan would not qualify for the Miller Act bonds. [App. 45-46]. The Army decided to disregard the correct advice of its own lawyer and delete the requirement that Verdan furnish the Miller Act bonds. Instead, the Army required that the subcontractor constructing the building (ultimately Blue Fox) provide bonds. (Faler Memorandum of Meeting dated August 3, 1993 [App. 47-48]). This protected the Army by assuring that a responsible party was obligated to construct the building, but it left Blue Fox without payment bond protection.

Blue Fox completed all work under its subcontract (Lumley Aff. ¶ 5 [App. 24], and the Army paid Verdan in full for Blue Fox's work ($231,759.08) plus another $37,722.91 "due to overcharges or misidentified charges made in the invoices submitted by Verdan," (Choate Aff. ¶ 9 [App. 60]). Verdan nonetheless failed to pay Blue Fox $46,586.14 owed under the subcontract (Lumley Aff. ¶ 5 [App. 24]).

Blue Fox notified the Army on May 26 and June 15, 1994 that Verdan had not paid it for completed work on the project. [App. 29-33]. Subsequent to receipt of these letters, the Army made the following payments to Verdan [App. 34]:

July 5, 1994	$54,561.27
August 25, 1994	30,073.06
October 11, 1994	1,498.00
	$86,132.33

Verdan did not complete the project and was eventually terminated by the Army (Choate Aff. ¶ 7 [App. 59]). After the termination, the Army still held $84,910.52 of contract funds (Choate Aff. ¶ 15 [61]).

The Army hired another contractor to complete Verdan's contract and do additional work not required of Verdan (Choate Aff. ¶ 12 [App. 60]). It used the $84,910.52 still in its hands to pay for the completion and for extra work outside the scope of Verdan's contract. (Choate Aff. ¶ 14 [App. 61]). The additional cost of the completion work and extra work was paid from other sources. (Choate Aff ¶ 14 [App. 61]).

Blue Fox filed the instant suit seeking, among other relief, an equitable lien on the contract funds and an injunction against their use for purposes other than payment of Blue Fox. (A copy of the Complaint is Appendix E to the Petition for *Certiorari*). The District Court granted the Army's motion for summary judgment on the ground that sovereign immunity barred the suit. (1996 WL 293363) The Ninth Circuit reversed in part and remanded the case to the District Court, 121 F.3d 1357 (9th Cir. 1997).

SUMMARY OF ARGUMENT

The Army received the benefit of Blue Fox's work, and Blue Fox was entitled to an equitable lien on all contract funds in excess of the cost to complete the project. When Blue Fox notified the Army that Verdan had failed to pay for Blue Fox's work, the Army became a stakeholder of the contract funds and had a duty either to pay Blue Fox directly or to withhold the amount owed to Blue Fox from the payments otherwise due Verdan.

The Army could not meet this duty by paying the wrong party, Verdan, at the expense of Blue Fox. The $86,132.33 which the Army wrongfully disbursed is still part of the contract balance. Blue Fox's equitable right to this contract fund is superior to any competing claim and prevents use of the fund for any purpose other than to pay Blue Fox.

Even if the Administrative Procedure Act, 5 U.S.C. § 702, did not waive sovereign immunity to allow Blue Fox to sue the United States to obtain payment, it certainly authorized a suit for injunctive relief to preserve the contract funds and restrict their prospective use.

ARGUMENT

The Miller Act, 40 U.S.C. § 270a, *et seq.*, required the Army to obtain performance and payment bonds from Verdan. If the Army had complied with the Miller Act, the payment bond surety would have paid Blue Fox and stated a claim to the contract funds as a subrogee of Blue Fox. Since the Army did not obtain the required bond, this case presents the issue which this Court found was not present in *United States v. Munsey Trust Company*, 332 U.S. 234, 67 S.Ct. 1599, 91 L. Ed. 2022 (1947):

> We need not decide whether laborers and materialmen would have any claim to the retained percentages, if both contractor and surety failed to pay them.

332 U.S. at 242.

A. The Army was a Stakeholder of the Contract Funds Claimed by Blue Fox and Verdan.

Upon receiving notice that subcontractors or suppliers are unpaid, the United States becomes a "stakeholder" of any funds which are due and payable under the contract. That is, the contracting agency owes the payment to someone, and this is true whether or not the contract work is complete. In *Balboa Ins. Co. v. United States*, 775 F.2d 1158 (Fed. Cir. 1985), the court stated:

> We agree with the conclusion of the Court of Claims that, upon notification by the surety of the unsatisfied claims of the materialmen, the Government became a stakeholder with respect to the amount not yet expended under the contract that it holds at the time of notification of default. However, we can discern no reasonable basis for the Government's distinction between retainages and progress payments when, as in this case, the surety informed the Government of the contractor's alleged breach before the payment was disbursed.

Some courts, including the Federal Circuit in *Balboa*, have drawn a distinction between progress payments during contract performance and payments after completion of the work in terms of the standard by which the government's action will be judged. Before completion, the government has its own interest in seeing that the work is completed promptly, and that interest has to be factored in with the unpaid subcontractor's equitable claims. This gives the government some discretion in handling a progress payment as opposed to an unconditional duty not to pay a defaulting contractor after the work is physically complete. *Balboa Ins. Co., supra*; *Argonaut Ins. Co. v. United States*, 434 F.2d 1362 (Ct. Cl. 1970); *Royal Indemnity Co. v. United States*, 529 F.2d 1312 (Ct. Cl. 1970); *United States Fidelity & Guaranty Co. v. United States*, 676 F.2d 622 (Ct. Cl. 1982); *United States Fidelity & Guaranty Co. v. United States*, 475 F.2d 1377 (Ct. Cl. 1973).

In the instant case, the District Court granted the Army's motion for summary judgment on sovereign immunity grounds, and the Ninth Circuit reversed and remanded for further proceedings. On remand, Blue Fox can attempt to prove that at the time Blue Fox gave written notice that it had not been paid,[6] the Army held sufficient funds both to complete the contract and pay Blue Fox for its work,[7] and that under the factors set out in *Balboa* and other similar cases the Army abused its discretion in releasing payments to Verdan after notice of its default by failing to pay Blue Fox.

For purposes of this appeal, the issue is jurisdiction to hear Blue Fox's case, not the ultimate merits of that case, and the Army should be considered a mere stakeholder of the contract funds claimed by Blue Fox and Verdan.

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[6] May 26 and June 15, 1994.

[7] Subsequent to receipt of Blue Fox's notice, the Army paid $86,132.33 to Verdan and $84,910.53 of contract funds to Dynamic Concepts, Inc. to complete the project and do some additional work. The total paid to Dynamic Concepts ($126,772.78) exceeded the then available contract funds ($84,910.53) by $41 862.25. If the money wrongfully paid to Verdan had remained in the Army's hands, it could have paid the completion and other costs with $44,270.08 left to pay Blue Fox. In addition, the Army admits that Verdan was overpaid $37,722.27 for the construction work, and some part of the money paid to the Dynamic Concepts was for work outside the scope of Verdan's contract. (Choate Aff. ¶ 9 [App. 60])

B. Blue Fox Had an Equitable Lien on the Contract Funds Superior to Any Competing Claim by Verdan.

This Court has consistently recognized the equitable claims of subcontractors and suppliers to be paid out of contract funds. In *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547 (1908), this Court held that a surety which had paid for the labor and material furnished for use in constructing a public building was subrogated to the rights of the persons it paid and accordingly had a claim to contract funds which was superior to the rival claim of an assignee of the contractor. The Court recognized that the surety's rights were derived from those of the laborers and materialmen:

> It paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the government from all equitable obligations to see that the laborers and supplymen were paid.

208 U.S. at 410.

In *United States v. Munsey Trust Company*, 332 U.S. 234, 67 S.Ct. 1599, 91 L.Ed. 2022 (1947), this Court held that the set off right of the United States was superior to the paying surety's

claim as subrogee of unpaid laborers and materialmen.[8] The court stated:

> But the surety urges that it is subrogated also to the rights of laborers and materialmen whom it paid and of the United States. From *Prairie State Nat. Bank of Chicago v. United States*, 164 U.S. 227, 17 S.Ct. 142, 41 L.Ed. 412, to *American Surety Co. of New York v. Sampsell*, 327 U.S. 269, 66 S.Ct. 571, 90 L.Ed. 663, we have recognized the peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available moneys ahead of others whose claims come from the advance of money. But in all those cases, the owner was a mere stakeholder and had no rights of its own to assert.

332 U.S. at 240.

The *Munsey Trust* court also found that the laborers and materialmen did not have *enforceable* rights against the United

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[8] The result in *Munsey Trust* has been criticized, *See Restatement of the Law Third, Suretyship and Guaranty* (American Law Institute, 1996) at § 34 and particularly the Reporter's Note to Comment d on p. 134; Mungall, "The Buffeting of the Subrogation Rights of the Construction Contract Bond Surety by *United States v. Munsey Trust Co.*," 46 *Ins. Couns. J.* 607 (1979), and limited to set off against a payment bond surety's claim. A performance bond surety's benefit to the obligee is more direct, and as a subrogee of the owner it prevails over a set off claim. *Trinity Universal Ins. Co. v. United States*, 382 F.2d 317 (5th Cir. 1967) *cert. den.* 390 U.S. 906 (1968); *Aetna Casualty & Surety Co. v. United States*, 845 F.2d 971 (Fed. Cir. 1988). In any event, this is not a set off case. The Army did not use the contract funds to pay an unrelated claim the United States may have had against Verdan. The Army was a stakeholder and paid Verdan.

States[9] and questioned the surety's ability to pay the laborers and materialmen and then assert their claims as if they had not been paid.

Any confusion in the *Munsey Trust* decision over the surety's subrogation rights was resolved by *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962), which limited *Munsey Trust* to set off cases in which the United States has its own claim to the contract funds and reaffirmed the rule of *Henningsen* that the paying surety's right to contract funds was superior to the competing claim of the contractor (or, in *Pearlman*, the contractor's trustee in bankruptcy). The *Pearlman* court held:

> We therefore hold in accord with the established legal principles stated above that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.

371 U.S. at 141.

The lower courts have consistently followed *Henningsen*, *Munsey Trust* and *Pearlman* to award the payment bond surety

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9 The *Munsey Trust* decision predated the 1976 amendments to the Administrative Procedure Act, and the court was not able to consider whether the waiver of sovereign immunity in § 702 would render a subcontractor's rights enforceable.

contract funds which the United States retains as a stakeholder[10] over competing claims by the contractor[11] or those claiming through the contractor such as trustees in bankruptcy[12] or assignee banks.[13]

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10 See generally, Mungall, "The Buffeting of the Subrogation Rights of the Construction Contract Bond Surety by *United States v. Munsey Trust Co.*" 46 *Ins. Coun. J.* 607 (1979); Bachrach, editor, *The Subrogation Database: Cases Concerning the Subrogation Rights of the Contract Bond Surety* (American Bar Association, 1995); Bachrach and Burch, "The Surety's Subrogation Rights" in Gallagher, editor, *The Law of Suretyship* (American Bar Association, 1993).

11 See, for example, *Home Indemnity Co. v. United States*, 376, F.2d 890 (Ct. Cl. 1967); *Fireman's Fund Ins. Co. v. United States*, 421 F.2d 706 (Ct. Cl. 1970); *Argonaut Ins. Co. v. United States*, 434 F.2d 1362 (Ct. Cl. 1970); *Int. Fidelity Ins. Co. v. United States*, 25 Cl. Ct. 469 (1992). *The Subrogation Database, Id.*, pages C211-C217.

12 *In re J.V. Gleason Co.*, 452 F.2d 1219 (8th Cir. 1971); *In re Dutcher Constr. Co.*, 378 F.2d 866 (2d Cir. 1967); *McAtee v. United States Fidelity & Casualty Co.*, 401 F.Supp. 11 (N.D. Fla. 1975); *In re Modular Structures*, 27 F.3d 72 (3rd Cir. 1994); *In re Pacific Marine Dredging and Constr.*, 79 B.R. 924 (Bankr.D. Ore. 1987); *In re Massart Co.*, 105 B.R. 610 (W.D. Wash. 1989); *In re Alcon Demolition, Inc.*, 204 B.R. 440 (Bankr. N.J. 1997); *Segovia Dev. Corp. v. Constructora Maza, Inc.*, 628 F.2d 724 (1st Cir. 1980). *Cf. Universal Bonding Ins. Co. v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d 366 (3rd Cir. 1992), which erroneously found the contract funds to be part of the bankruptcy estate but required them to be held in trust to pay the subcontractors and suppliers. *See The Subrogation Database, supra.*, pages C303-C313.

13 *In re Modular Structures*, 27 F.3d 72 (3rd Cir. 1994); *Transamerica Ins. Co. v. Barnett Bank of Marion Co.*, 540 So.2d 113 (Fla. 1989); *Kimberly-Clark Corp. v. Alpha Building Co.*, 591 F.Supp. 198 (N.D. Miss. 1984); *Mid Continent Casualty Co. v. First National Bank & Trust Co.*, 531 P.2d 1370 (Okla. 1975); *Royal Indemnity Co. v. United States*, 93 F.Supp. 891 (Ct. Cl. 1950). *See The Subrogation Database, supra.*, pages C261-C298.

In the instant case, of course, there is no surety, but the cases in which payment bond sureties have claimed contract funds are relevant because the sureties' claims are based in part on subrogation to the equitable rights of the laborers, materialmen and subcontractors whom the sureties paid. If a surety has a claim to contract funds by virtue of its subrogation to the rights of a subcontractor whom it paid, logically the subcontractor can assert the rights itself if there is no surety.[14]

When unpaid subcontractors have sued to recover contract funds, the courts have recognized their equitable right to payment. In at least three cases involving the U.S. Postal Service,[15] circuit courts awarded contract funds to subcontractors. In *Kennedy Elec. Co. Inc. v. United States Postal Service*, 508 F.2d 954 (10th Cir. 1974), the Postal Service failed to obtain Miller Act bonds and a subcontractor was unpaid. The Tenth Circuit relied on this Court's decisions in *Henningsen*, *Munsey Trust* and *Pearlman* to award full payment to the subcontractor out of funds retained by the Postal Service and wrongfully paid to the contractor's assignee. The court stated:

> In the case at bar the contractor failed to pay and there is no surety. Department had the benefit of the services and material furnished by the subcontractor and the asset created by that benefit was transferred to

14 *See generally*, Gallagher, "Unpaid Subcontractors' or Suppliers' Right to Payment Out of Contract Funds," *The Construction Lawyer*, Vol. 10, No. 1 (American Bar Association Forum Committee on the Construction Industry, January 1990).

15 Congress has waived sovereign immunity for the Postal Service in 39 U.S.C. § 401 which authorizes the Postal Service to sue and be sued.

> Service, which also has the retainage. Although the Supreme Court has not decided the specific point now in issue, there is no discernible difference between the equities of the sureties, which were upheld in Prairie State Bank and Henningsen, and the equities of the subcontractor now suing.

In *Active Fire Sprinkler Corp. v. U.S. Postal Service*, 811 F.2d 747 (2nd Cir. 1987), the subcontractor lost its rights against the contractor's sureties by letting the one year limitation period of the Miller Act[16] expire. It then sought payment out of contract funds in the hands of the Postal Service. The rival claimants were the unpaid subcontractor and the sureties, and the court held that the subcontractor could recover. The court stated:

> Active asserts that it had equitable rights in the Contract Balance held by USPS at the time this suit (the Lien Action) was commenced. We agree. It is not new law that unpaid subcontractors hold an equitable interest in a contract balance owed by a building owner to a general contractor.

811 F.2d at 755.

The Second Circuit emphasized that the equitable rights of the unpaid subcontractor were superior to any competing claim by the sureties even though the sureties had paid their entire bond penalty to other claimants. *American Surety Co. v. Westinghouse Electric Mfg. Co.*, 296 U.S. 133, 56 S.Ct. 9, 80 L.Ed. 105 (1935) and *American Surety Co. of New York v.*

16 40 U.S.C. § 270b(b) (1998).

Sampsell, 327 U.S. 269, 66 S.Ct. 571, 90 L.Ed. 663 (1946), reached the same conclusion.

Wright v. U.S. Postal Service, 29 F.3d 1426 (9th Cir. 1994), reversed the dismissal of an equitable lien suit by three unpaid subcontractors against the Postal Service. The decision addresses jurisdictional issues and, citing *Pearlman*, *Henningsen* and *Active Fire Sprinkler*, assumes that the unpaid subcontractors have a cause of action to establish and enforce equitable liens.

These Postal Service cases, of course, relied upon the waiver of sovereign immunity in the Postal Reorganization Act.[17] Although subcontractors' attempts to use the Tucker Act[18] to sue agencies for which Congress has not waived sovereign immunity have failed on jurisdictional grounds, the courts have recognized the existence, if not the enforceability, of the subcontractors' equitable liens on contract funds.

In *United States Fidelity & Guaranty Co. v. United States*, 475 F.2d 1377 (Ct.Cl. 1973), the Court of Claims held that unpaid subcontractors could not sue the United States but recognized their equitable rights to the contract funds. The Court urged the Navy either to pay the subcontractors voluntarily or file an interpleader. In *United Electric Corp. v. United States*, 647 F.2d 1082 (Ct.Cl.) *cert. den.* 454 U.S. 863 (1981), the Court of Claims reconsidered its holding in *USF&G* in light of the Tenth Circuit's *Kennedy Electric* decision. The Court of Claims distinguished *Kennedy Electric* on the ground

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[17] 39 U.S.C. §§ 101, *et seq.* The waiver of sovereign immunity is § 401(1).

[18] 28 U.S.C. § 1491.

that Congress had waived sovereign immunity for suits against the Postal Service, and again held that the Tucker Act does not grant jurisdiction over a direct subcontractor suit. The Court also, however, urged that the subcontractor be paid, and stated:

> But the existence of equitable rights in subcontractors (as well as other laborers and materialmen) does not mean that they, too, can sue the United States directly for their part of the retained funds--perhaps unfortunately, Congress has not consented to that class of suit and the subs' right (*sic.*) remain unenforceable against the United States under the Tucker Act.

647 F.2d at 1086.

In the instant case, therefore, Blue Fox had an equitable right to payment out of any contract funds which exceeded the cost to complete the contract. For present purposes, the Army should be considered a stakeholder of the funds in its hands at the time Blue Fox gave notice of Verdan's failure to pay for Blue Fox's work. The competing claimants were Blue Fox and Verdan, and as between them Blue Fox had superior equities.

C. Upon Receipt of Notice From Blue Fox, the Army had a Duty Either to Pay Blue Fox, Withhold the Amount Claimed or File an Interpleader.

When Verdan failed to pay Blue Fox, it breached its contractual obligation to the Army just as surely as if it had failed to construct the building per the project plans and specifications. Indeed, when it notified the SBA that Verdan was in default, one of the breaches upon which the Army relied was the failure to pay Blue Fox. [App. 36]. In *Pearlman v.*

Reliance Ins. Co., 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962), this Court held that the contractor would have been entitled to the contract fund "had he completed his job and paid his laborers and materialmen." 371 U.S. at 141. *Martin v. National Surety Co.*, 300 U.S. 588, 57 S.Ct. 531, 81 L.Ed. 822 (1937), held that a contract payment to an assignee should be turned over to pay laborers and materialmen in part because the failure to pay them was a breach of both the statutory payment bond and the underlying construction contract.[19] Verdan was not entitled to receive the contract funds.

When the United States is a stakeholder of contract funds and is notified that a subcontractor is unpaid, it has the obligation to respect the equitable rights of the subcontractor. Even if the subcontractor cannot sue to enforce its rights, the United States cannot pay the contract funds to a competing claimant with an inferior claim.

United States Fidelity & Guaranty Co. v. United States, supra., stated:

> The issue is, quite simply, to whom should the Government pay this fund? The fund would ordinarily be owed to the prime contractor had it paid all of its obligations to the subcontractors, but when the Government is in the position of a stakeholder, it is not free simply to pay the contractor when the surety has given adequate notice of other competing claims to the fund.

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19 Lower courts following *Pearlman* and holding that failure to pay subcontractors bars the prime contractor's claim to contract funds include *In re Modular Structures*, 27 F.3d 72 (3rd Cir. 1994) and *In re Pacific Marine Dredging and Constr.*, 79 B.R. 924 (Bankr. D. Ore. 1987).

475 F.2d at 1380.

On the other hand, the United States cannot pay the surety if subcontractors remain unpaid. *North Denver Bank v. United States*, 432 F.2d 466 (Ct.Cl. 1970); *United States Fidelity & Guaranty Co. v. United States, supra.*

The result is that the United States must either voluntarily pay the subcontractor, file an interpleader or hold the contract funds. *United Electric Corp. v. United States, supra.* states:

> As we have done before, we stress that the United States may voluntarily choose to make payment . . . and we believe that it has a nonenforceable obligation to do so, when and if it becomes clear that United had a valid claim, that contract retainages or other unexpended funds under the contract are available for such payment, and that, if those funds are not paid out, the Government will be receiving a windfall which it should not have.

647 F.2d at 1087.

The Court of Claims in *United States Fidelity & Guaranty Co. v. United States, supra.*, stated:

> In an effort to dispose of this problem once and for all, this court recommends that the Navy simply pay the contesting laborers and materialmen according to the pro rata division employed by the Massachusetts District Court or file an action in interpleader in that or another appropriate court.

475 F.2d at 1383.

D. The Army Could Not Decide the Competing Claims of Blue Fox and Verdan by Paying the Wrong Party.

In *Newark Ins. Co. v. United States*, 169 F.Supp. 955 (Ct.Cl. 1959), the court stated:

> Surely a stakeholder, caught in the middle between two competing claimants, cannot, in effect, decide the merits of their claims by the mere physical act of delivering the stake to one of them. If his position as stakeholder becomes uncomfortable, and the claimants do not take steps to get a judicial solution of the question, the law has provided him with an interpleader proceeding by which he can deposit the stake in court and walk out free of the annoyance of being in the middle.

Home Indemnity Co. v. United States, 376 F.2d 890 (Ct.Cl. 1967), followed *Newark* and held:

> In view of plaintiff's equitable rights in the fund, which were superior to those of the contractor, the Government had no right as a stakeholder to settle the question unilaterally by paying the fund to the contractor.

Cases following the rule of *Newark Ins.* and *Home Indemnity* include *District of Columbia v. Aetna Ins. Co.*, 462 A.2d 428 (D.C. 1983); *Fireman's Fund Ins. Co. v. United States*, 421 F.2d 706 (Ct. Cl. 1970); *Argonaut Insurance Co. v. United States*, 434 F.2d 1362 (Ct. Cl. 1970); *United States Fidelity Guaranty Co. v. United States*, 475 F.2d 1377 (Ct. Cl. 1973); *Great American Ins. Co. v. United States*, 492 F.2d 821

(Ct. Cl. 1974); *International Fidelity Ins. Co. v. United States*, 25 Cl.Ct. 469 (1992); and *Transamerica Premier Ins. Co. v. United States*, 32 Fed.Cl. 308 (1994).

E. The Amount Wrongfully Paid Verdan Remains Part of the Contract Balance

At the time Blue Fox filed suit, the Army still held sufficient contract funds to pay Blue Fox. These funds apparently were used to pay for completion of the work. If the wrongful payments to Verdan are included, however, the Army had enough money both to complete the work and pay Blue Fox.

This appeal involves sovereign immunity and the District Court's jurisdiction to hear Blue Fox's case not the merits of that case. Even if the following argument that the wrongful payments to Verdan must be disregarded were incorrect, the District Court had jurisdiction to decide Blue Fox's claim to an equitable lien on the funds unquestionably in the Army's possession.

After receiving notice that Verdan had failed to pay Blue Fox, the Army paid Verdan $86,132.33. The respective claims of Blue Fox and Verdan to the contract funds, however, must be judged as of the date Blue Fox gave notice of Verdan's default.

Balboa Ins. Co., supra, quoting from *National Surety Corp. v. United States*, 319 F.Supp. 45 (N.D. Ala. 1970) states:

> The surety's rights apply to the *total fund*, no matter what it is called, which remains in the hands of the United States (or any owner-obligee) *at the time notice of default* under its bond is established.

775 F.2d. at 1163, emphasis by the court in *Balboa*.

Transamerica Insurance Co. v. United States, 31 Fed. Cl. 532 (1994), states:

> Similarly, Transamerica may assert a claim to the contract balance as it existed when Transamerica notified defendant on February 6, 1990 of Hirt's default.

31 Fed.Cl. at 536.

The amount of which the Army was a stakeholder, therefore, is the $171,042.85 in its possession when Blue Fox gave written notice. Subsequently, of course, the Army paid Verdan $86,132.33 out of that sum and used the balance of $84,910.52 to complete the work.

If the Army had no contract funds at the time Blue Fox gave notice, then Blue Fox would have no claim. An unpaid subcontractor does not have a right to be paid by the United States. It has an equitable lien or security interest in the particular contract funds held by the United States.

That equitable lien can be defeated by a superior right to the fund such as the right of the United States to complete the project or, under *Munsey Trust*, to setoff an unrelated debt owed by the prime contractor against the contract fund.[20] It cannot,

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[20] Since the contract fund is not owed to the contractor it is not logical to allow the setoff of a debt owed by the contractor against funds owed to the surety. The Surety Association respectfully disagrees with the result in *Munsey Trust*, see Note 8 *supra*., but *Munsey Trust* also explicitly states that it is not considering the rights of subcontractors if neither the contractor nor the surety paid them. The Court at least left open the possibility that the equities of an unpaid subcontractor would outweigh the government's right of setoff.

however, be defeated simply by paying the fund to the wrong party.[21]

In *Pearlman v. Reliance Ins. Co., supra*. the contract fund had actually been paid to the contractor's trustee in bankruptcy who argued that it was property of the bankruptcy estate. The Court stated the issue as:

> So here if the surety at the time of adjudication was, as it claimed, either the outright legal or equitable owner of this fund, or had an equitable lien or prior right to it, this property interest of the surety never became a part of the bankruptcy estate to be administered, liquidated, and distributed to general creditors of the bankrupt.

371 at U.S. 136.

The Court rejected the trustee in bankruptcy's argument and held that the fund was the property of the subrogated surety.

In *Martin v. National Surety Co.*, 300 U.S. 588, 57 S.Ct. 531, 81 L.Ed. 822 (1937), the contract funds were paid to an assignee of the defaulting prime contractor who was compelled to pay them into Court pending a decision. The Court awarded the fund to the unpaid laborers and materialmen.

Thus, the payment of the fund to the contractor's assignee or trustee did not terminate the materialmen's equitable lien. In

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[21] See Part D., *supra*.

Martin and *Pearlman* the funds were under the Court's control, so there was no need to address the owner's possible liability. Both *Pearlman* and *Martin*, however, recognize the existence of an equitable lien which was not discharged by the fact of payment.

In *Kennedy Elec. Co. v. United States Postal Service*, 508 F.2d 954 (10th Cir. 1974) the money which the Postal Service admitted it held was insufficient to award the subcontractor full payment, but the Postal Service had made a progress payment to the defaulting contractor's assignee with knowledge that the subcontractor was unpaid. The Court treated both the money admittedly in the Postal Service's possession and the progress payment as "retainage" (508 F.2d at 958) and held:

> The subcontractor has an equitable lien both on the fund remaining in the Service's hands and on the money wrongfully paid to the assignee.

508 F.2d at 960.

Active Fire Sprinkler v. United States Postal Service, 811 F.2d 747 (2nd Cir. 1987) also involved a claim to funds which had purportedly been disbursed with knowledge that the subcontractor was unpaid. The Second Circuit held that payment of the funds on which the subcontractor sought to establish its lien to the wrong party had no effect on the equitable lien. The Court held that the subcontractor was entitled to recover from the Postal Service "based upon the Contract Balance held by USPS at the time the Lien Action was commenced." 811 F.2d at 758.

Blue Fox's equitable lien or security interest attached to the funds in the Army's hands when the Army received notice that

Verdan had not paid Blue Fox. The lien was an *in rem* interest not a cause of action against the Army. The lien was not defeated by wrongful payments to Verdan, and Blue Fox's rights remain in place against the contract balance less amounts paid to complete the work.

F. At the Very Least, Blue Fox is Entitled to Equitable Relief Preserving the Contract Fund.

In *Bowen v. Massachusetts*, 487 U.S. 879, 108 S.Ct. 2722, 101 L.Ed.2d 749 (1988), the District Court reversed the administrative disallowance of certain Medicaid costs. The Court of Appeals affirmed that aspect of the District Court's decision and directed that the case be remanded to the Secretary of the Department of Health and Human Services. The Court of Appeals assumed the Secretary would abide by the court's interpretation of the Medicaid Act but expected a suit in the Claims Court would be necessary to recover past due funds if that assumption was wrong. Both sides' petitions for *certiorari* were granted. The Secretary argued that the Claims Court had exclusive jurisdiction and Massachusetts argued that the District Court could grant it monetary relief short of "money damages."

The majority opinion in *Bowen* states:

> We agree with the position advanced by the State in its cross-petition -- that the judgments of the District Court should have been affirmed in their entirety--for two independent reasons. First, neither of the District Court's orders in these cases was a "money judgment," as the Court of Appeals held. The first order (followed in the second, see Part I, supra) simply "reversed" the "decision of the Department Grant Appeals Board of the United States Department

of Health and Human Services in Decision No. 438 (May 31, 1983)." It is true that it describes Decision No. 438 as one that had disallowed reimbursement of $6,414,964 to the State, but it did not order that amount to be paid, and it did not purport to be based on a finding that the Federal Government owed Massachusetts that amount, or indeed, any amount of money. Granted, the judgment tells the United States that it may not disallow the reimbursement on the grounds given, and thus it is likely that the Government will abide by this declaration and reimburse Massachusetts the requested sum. But to the extent that the District Court's judgment engenders this result, this outcome is a mere by-product of that court's primary function of reviewing the Secretary's interpretation of federal law.

> Second, even if the District Court's orders are construed in part as orders for the payment of money by the Federal Government to the State, such payments are not "money damages."

487 U.S. at 909-910.

Justice White's Concurring Opinion in *Bowen* agrees with the majority's interpretation of the District Court's decision, and thus with the majority's first reason to affirm the District Court, but not with the proposition that 5 U.S.C. § 702 allowed entry of an Order for the payment of money. 487 U.S. at 912.

Justice Scalia's dissenting opinion, joined by Chief Justice Rehinquist and Justice Kennedy, rejects as form over substance the first alternative advanced by the majority. 487 U.S. at 915-917. The dissenting opinion also states, however, that but for

the availability of a remedy in the Claims Court (and, therefore, a § 704 bar to Massachusetts' action)[22] the District Court could have granted prospective equitable relief:

> I agree with the Court that sovereign immunity does not bar respondent's actions insofar as they seek injunctive or declaratory relief with prospective effect. An action seeking an order that will prevent the wrongful disallowance of future claims is an action seeking specific relief and not damages, since no damage has yet occurred.

487 U.S. at 921-922.

Each Justice, therefore, agreed that 5 U.S.C. § 702 would have waived sovereign immunity for Massachusetts to seek an Order from the District Court with only prospective effect to prevent wrongful disallowance of future claims.

Hubbard v. Administrator, Environmental Protection Agency, 982 F.2d 531 (D.C. Cir. 1992) upheld an order that the Environmental Protection Agency ("EPA") employ Mr. Hubbard even though it found that § 702 did not waive sovereign immunity to allow the court to award him back pay. Mr. Hubbard clearly would be paid by EPA in the future as a consequence of his coerced employment, but the Court had no difficulty with that aspect of the case.

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[22] 5 U.S.C. § 704 states, in part, "Agency action made reviewable by statute and final agency action for which there is no other adequate remedy in a court are subject to judicial review." In the instant case Blue Fox clearly had no adequate remedy in the Claims Court.

Dia Navigation Co. v. Pomeroy. 34 F.3d 1255 (3rd Cir. 1994) granted a declaratory judgment voiding the Immigration and Naturalization Service's rule on detention of stowaways pending decision on their asylum requests even though it also held that payment for the cost of detaining the four specific stowaways involved was "money damages" not available under § 702. Again, the court ordered equitable relief which would have a prospective economic impact, but it stopped short of an order compelling the payment of money.

Applying this minimum scope of § 702 to the facts of the instant case, the District Court could have done formally what the Court of Claims repeatedly stated informally and enjoined any prospective use of the contract funds for a purpose other than paying Blue Fox. The Court of Claims held that the Tucker Act did not give it jurisdiction over suits by unpaid subcontractors, but it also recognized the equitable rights of the subcontractors and urged the government to use remaining contract funds to pay the subcontractors either directly or by filing an interpleader. Of course, the Court of Claims could not compel the contracting agency to do so, but it did reject any competing claim.

In its Complaint in the District Court (Appendix E to the Petition for *Certiorari*), Blue Fox specifically asked for an Order declaring that it had an equitable lien on retained funds under the contract (¶ 2(a) of the prayer for relief) and that the Army be enjoined from paying any further moneys under the contract until Blue Fox is paid for its work (¶ 2(f) of the prayer for relief). Even if this Court does not agree with the Ninth Circuit that "an action for specific performance for the payment of money is not an action for money damages," 121 F.3d at 1359, it does not have to agree with the District Court that sovereign immunity barred all of Blue Fox's claims. At least,

Blue Fox was entitled to an Order preserving the contract balance at the time it gave notice of its claim and enjoining payment of the contract funds for any purpose other than completion of the project (which has now been accomplished) and payment of Blue Fox.

The wrongful "agency action" in the instant case was not the Army's failure to require Miller Act bonds. That failure may have cost Blue Fox $46,586.14, but an award on that basis would be "money damages" for the Army's breach of its statutory duty. It would be a substitute for the money the surety would have paid had the Army complied with the Miller Act. The operative wrongful agency action was the Army's payment of $86,132.33 to Verdan, after notification that Verdan had failed to pay Blue Fox, in violation of Blue Fox's equitable lien on the contract balance.

Congress appropriated money to pay for the Umatilla Army Depot Switch project. The Army's obligation was to spend that money according to the law. At least $86,132.33 of Congress' appropriation (less legitimate completion costs) is still in the Army's hands. Blue Fox is entitled to an Order preserving that fund. If there is any doubt about Congressional appropriations, it is for the money wrongfully paid Verdan not the contract balance on which Blue Fox has an equitable lien.

Blue Fox is not seeking an "alternative" to the remedy Congress provided in the Miller Act. The payment bond requirement of the Miller Act protects subcontractors on federal projects, but it was not intended to do so by reducing any rights they otherwise had including an equitable lien on unexpended contract funds. *Pearlman v. Reliance Ins. Co., supra.* rejected that argument stating:

> Neither this slight difference in the new and the old Acts nor any other argument presented persuades us that Congress in passing the Miller Act intended to repudiate equitable principles so deeply imbedded in our commercial practices, our economy, and our law as those spelled out in the Prairie Bank and Henningsen cases.

371 U.S. at 140.

The Miller Act did not set parameters for suits by subcontractors against the United States. It does not "impliedly forbid" such suits under the APA. It would be ironic indeed if a statute which was supposed to help assure payment for work on federal projects could be used to prevent such payment.

Finally, the limited relief urged here by the Surety Association would be completely consistent with the long-standing precedent of this Court and the specialized courts dealing with federal contracts. These Courts have repeatedly recognized that unpaid subcontractors have an equitable right to be paid out of contract funds superior to any competing claim by the defaulting contractor. The Court of Claims especially was adamant that even if the Tucker Act did not give it jurisdiction over a suit by unpaid subcontractors, it would preserve the contract funds for the benefit of the subcontractors and prevent anyone else from obtaining them while the subcontractors were unpaid.

CONCLUSION

Whether Blue Fox can or cannot sue the United States, pursuant to the Administrative Procedure Act, for specific performance of an equitable obligation to pay money, it had an equitable lien on the contract funds held by the Army. The Army's wrongful payment to Verdan did not discharge or terminate that lien, and the Army still holds the $86,132.33 wrongfully paid to Verdan (less any legitimate completion costs chargeable against it). There is no rival claimant entitled to those funds, and even if the Army cannot be compelled to pay Blue Fox under the APA waiver of sovereign immunity, it can be ordered not to use the contract funds for any other purpose.

The Army's first mistake was its failure to secure the bonds required by the Miller Act. The Army's second mistake was releasing funds to Verdan after notice that Blue Fox was unpaid. Both mistakes prejudiced Blue Fox which lost the bond protection mandated by Congress and, under the District Court's decision, the equitable security established by the case law. To date, the winner is Verdan, the defaulting prime contractor, which neither paid its bills nor completed its work but received the contract funds. The loser, through no fault of its own, is Blue Fox which performed its work but is unpaid. This unhappy state of affairs was caused by the Army's mistakes, and to the extent possible under the law, the loss should be shifted from the innocent Blue Fox to the culpable Army. This would place the loss on the party in a position to have prevented it, and would be consistent with this Court's long established recognition of the equitable rights of unpaid subcontractors on public works projects.

Amicus Curiae The Surety Association of America does not take a position on whether the sovereign immunity waiver of 5 U.S.C. § 702 permits an Order for specific performance of the Army's equitable obligation to pay Blue Fox out of available contract funds. If it does not, however, the Surety Association requests that the Court hold that § 702 does permit this action to go forward for Blue Fox to prove that it had an equitable lien on the contract funds in the Army's hands, that upon receipt of notice that Blue Fox was unpaid, the Army became a stakeholder of the amount owed Blue Fox, that the wrongful payments to Verdan did not destroy Blue Fox's equitable lien and that the Army can be enjoined from using the contract funds for any purpose other than payment of Blue Fox.

Respectfully submitted,

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